

$$\begin{array}{l}
 \text{Interest expense} \times \frac{\text{General limitation assets that are not tax exempt}}{\text{Worldwide assets that are not tax exempt}} \\
 \\
 \$60,000 \times \frac{\$2,000,000}{(\$100,000 + \$900,000 + \$2,000,000)} = \$40,000 \\
 \\
 \frac{\text{Nonexempt foreign assets}}{20 \text{ percent of Z stock value} + \text{Nonexempt domestic assets} + \text{Nonexempt foreign assets}} \\
 \\
 \text{To domestic source income:} \\
 \\
 \text{Interest expense} \times \frac{\text{Domestic assets that are not tax exempt}}{\text{Worldwide assets that are not tax exempt}} \\
 \\
 \$60,000 \times \frac{\$100,000 + \$900,000}{(\$100,000 + \$900,000 + \$2,000,000)} = \$20,000 \\
 \\
 \frac{20 \text{ percent of Z stock value} + \text{nonexempt domestic assets}}{20 \text{ percent of Z stock value} + \text{Nonexempt domestic assets} + \text{Nonexempt foreign assets}}
 \end{array}$$

(h) *Effective dates.* In general, the rules of this section, as well as the rules of §§1.861-9T, 1.861-10T, 1.861-11T, 1.861-12T, and 1.861-14T shall apply for taxable years beginning after December 31, 1986. In the case of corporate taxpayers, transition rules set forth in §1.861-13T provide for the gradual phase-in of certain the provisions of this and the foregoing sections. However, the following rules are effective for taxable years commencing after December 31, 1988:

(1) Section 1.861-9T(b)(2) (concerning the treatment of certain foreign currency borrowings),

(2) Section 1.861-9T(d)(2) (concerning the treatment of interest incurred by nonresident aliens),

(3) Section 1.861-10T(b)(3)(ii) (providing an operating costs test for purposes of the nonrecourse indebtedness exception), and

(4) Section 1.861-10T(b)(6) (concerning excess collateralization of nonrecourse borrowings).

In addition, §1.861-10T(e) (concerning the treatment of related controlled foreign corporation indebtedness) is effective for taxable years commencing after December 31, 1987. For rules for taxable years beginning before January

1, 1987, and for later years to the extent permitted by §1.861-13T, see §1.861-8 (Revised as of April 1, 1986).

[T.D. 8228, 53 FR 35474, Sept. 14, 1988, as amended by T.D. 8286, 55 FR 3054, Jan. 30, 1990; T.D. 8337, 56 FR 10369, Mar. 12, 1991; T.D. 8597, 60 FR 36679, July 18, 1995; T.D. 8805, 64 FR 1509, Jan. 11, 1999; T.D. 8973, 66 FR 67083, Dec. 28, 2001]

#### § 1.861-9 Allocation and apportionment of interest expense.

(a) through (h)(4) [Reserved]. For further guidance, see §1.861-9T(a) through (h)(4).

(h)(5) *Characterizing stock in related persons*—(i) *General rule.* Stock in a related person held by the taxpayer or by another related person shall be characterized on the basis of the fair market value of the taxpayer's pro rata share of assets held by the related person attributed to each statutory grouping and the residual grouping under the stock characterization rules of §1.861-12T(c)(3)(ii), except that the portion of the value of intangible assets of the taxpayer and related persons that is apportioned to the related person under §1.861-9T(h)(2) shall be characterized on the basis of the net income before interest expense of the related

person within each statutory grouping or residual grouping (excluding income that is passive under § 1.904-4(b)).

(ii) *Special rule for section 936 corporations regarding alternative minimum tax.* For purposes of characterizing stock in a related section 936 corporation in determining foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a), the rules of § 1.861-9T(g)(3) shall apply and § 1.861-9(h)(5)(i) shall not apply. Thus, for taxable years beginning after December 31, 1989, and before January 1, 1994, stock in a related section 936 corporation is characterized for alternative minimum tax purposes as a foreign source passive asset because the stock produces foreign source passive dividend income under sections 861(a)(2)(A), 862(a)(2), and 904(d)(2)(A) and the regulations under those sections. For taxable years beginning after December 31, 1993, stock in a related section 936 corporation would be characterized for alternative minimum tax purposes as an asset subject to the separate limitation for section 936 corporation dividends because the stock produces foreign source dividend income that, for alternative minimum tax purposes, is subject to a separate foreign tax credit limitation under section 56(g)(4)(C)(iii)(IV). However, stock in a section 936 corporation is characterized as a U.S. source asset to the extent required by section 904(g). For the definition of the term *section 936 corporation*, see § 1.861-11(d)(2)(ii).

(iii) *Effective date.* This paragraph (h)(5) applies to taxable years beginning after December 31, 1989.

[T.D. 8916, 66 FR 272, Jan. 3, 2001]

**§ 1.861-9T Allocation and apportionment of interest expense (temporary regulations).**

(a) *In general.* Any expense that is deductible under section 163 (including original issue discount) constitutes interest expense for purposes of this section, as well as for purposes of §§ 1.861-10T, 1.861-11T, 1.861-12T, and 1.861-13T. The term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year. The method of allocation and apportion-

ment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. Exceptions to the fungibility rule are set forth in § 1.861-10T. The fungibility approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. When borrowing will generally free other funds for other purposes, and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes. Consistent with the principles of fungibility, except as otherwise provided, the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate, have generated, or could reasonably have been expected to generate. In the case of the interest expense of members of an affiliated group, interest expense shall be considered to be allocable to all gross income of the members of the group under § 1.861-11T. That section requires the members of an affiliated group to allocate and apportion the interest expense of each member of the group as if all members of such group were a single corporation. For the method of determining the interest deduction allowed to foreign corporations under section 882(c), see § 1.882-5.

(b) *Interest equivalents—(1) Certain expenses and losses—(i) General rule.* Any expense or loss (to the extent deductible) incurred in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time shall be subject to allocation and apportionment under the rules of this section if such expense or loss is substantially incurred in consideration of the time value of money. However, the allocation and apportionment of a loss under this paragraph (b) shall not affect the characterization of such loss as capital or ordinary for other purposes of the Code and the regulations thereunder.